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A3840-11.15-F

U.S. Chamber of Commerce

Economic Policy Division

Policy Working Papers

April 1988

Number 15

INFLATION: THE UNTOLD STORY

by
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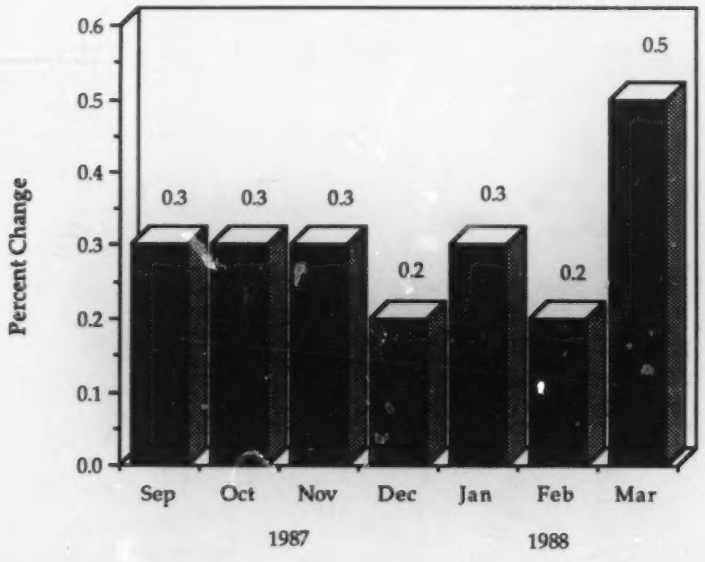
Last week's release of the consumer price index (CPI) for March has revived the nation's collective inflation phobia. The 0.5 percent March increase was largely due to a record jump in apparel and increases in food and housing prices. The following graph, showing monthly increases in the consumer price index, was reproduced in every major newspaper last week. It depicts in vivid terms the basis for current concerns over a resurgence in inflation.

Monthly Increase in Consumer Prices



This chart, however, is misleading. It does not tell the whole inflation story. With the release of March data, we now have inflation figures for the first quarter of 1988.

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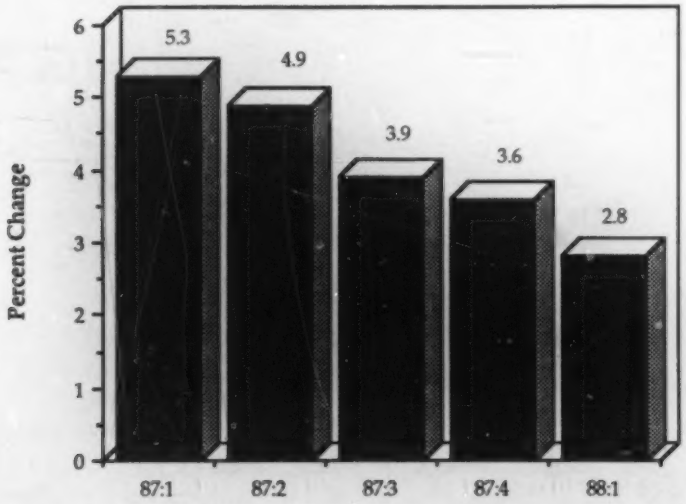
When the quarterly data are plotted, the real inflation trend is revealed, and it is starkly different than the one portrayed in the media last week. What we see is not a sharp acceleration in inflation, but the fourth consecutive quarter of *declining* inflationary pressures.

Quarterly Growth in Consumer Prices

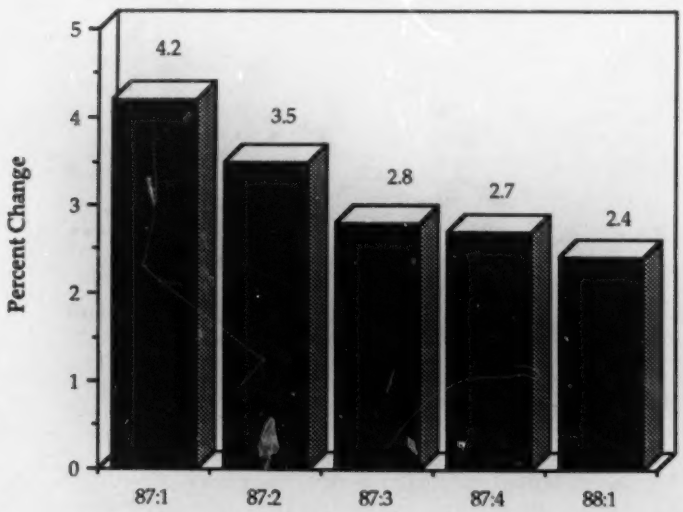
(Seasonally Adjusted Annual Rate)



This trend is consistent with the declining ratcheting down of inflation we have been experiencing since 1980. These numbers are not a fluke or a statistical construct; the decline in inflationary pressures as measured by the CPI is corroborated by the implicit deflator for gross national product (GNP), a broader measure of inflation. As demonstrated in the chart below, the GNP deflator paints the same picture of steady declines.

Implicit GNP Deflator

(Seasonally Adjusted Annual Rate)

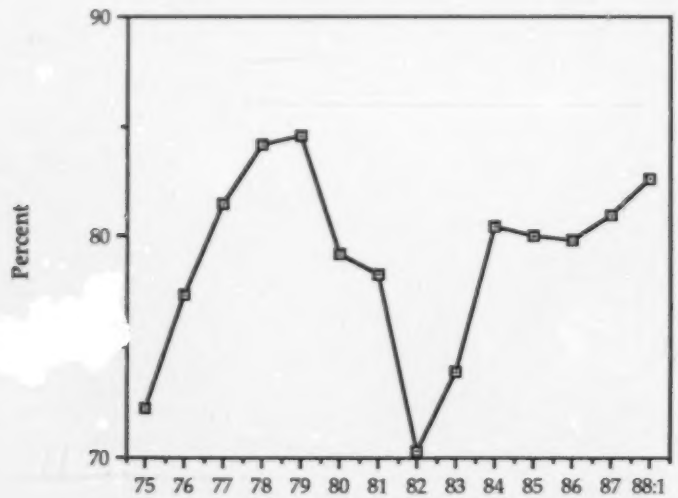


This, of course, is not the first time that the inflation alarm has been sounded during the course of our 66-month economic expansion. It seems that whenever the economy shows a bit more strength than had been anticipated, the inflation monster is revived.

Why do economic analysts posit that economic growth is inflationary? In short, it is assumed that there are "limits to growth," that is, as production increases, firms and industries will reach the limits of their productive capacity, bottlenecks and shortages will arise, and inflation will begin to heat up. These same so-called "limits" apply to the labor markets. The argument there is that continued improvements in the unemployment rate and demographic shifts could spell a resurgence in wage pressures. In addition, there are other developments that set off inflation alarms, including the fears of a possible resurgence in oil prices, the lagged effect of the decline in the value of the dollar, and increases in commodity prices.

An examination of these factors, however, shows that inflation fears based on them are exaggerated. The following chart shows the capacity utilization rate in manufacturing. After rising sharply from the depths of the 1981-82 recession, operating rates stagnated for most of 1985 and 1986 and began to trend up again in 1987. Yet, at 82.6 percent for the first quarter of this year, operating rates in manufacturing are well below the previous peak of 87.7 percent (in 1973). In addition, this view assumes that plant capacity is a given which cannot be changed. The truth is that American firms have been expanding their capacity to produce since the recovery began. Investment in producers' durable equipment, for instance, has risen by 17.9 percent from the first quarter of last year.

Capacity Utilization in Manufacturing

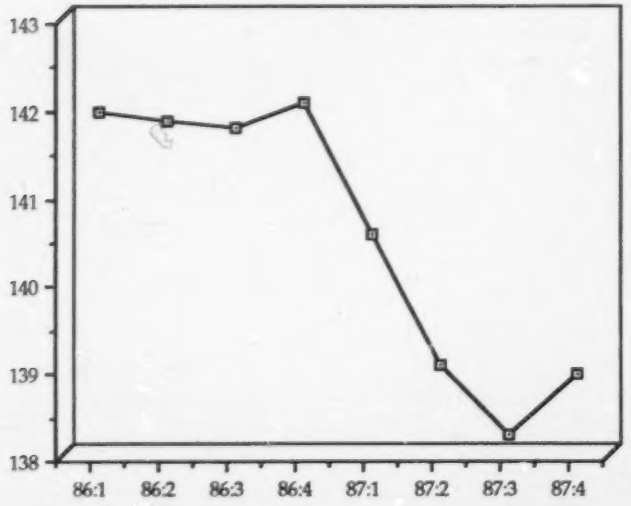


In the U.S. economy, employee compensation accounts for approximately two-thirds of national income, and is, therefore, a major component of business costs. Moderate wage pressures during the past several years are, therefore, counted among

the reasons why inflation has subsided. Clearly, one of the reasons why wage pressures remained moderate was the high degree of foreign and domestic competition in labor markets. The concern at this juncture is that as the economy continues to grow, the demand for labor in some industries and regions has begun to rise faster than the supply, leading to an increase in wages and salaries. This concern is reflected nationwide in the fact that the unemployment rate is at a decade low of 5.6 percent. Yet, while the economy continues to create new jobs and the unemployment rate has declined steadily, labor productivity (output per hour) has also risen, due primarily to increases in investment. In the manufacturing sector, productivity rose by 3.7 percent in 1986 and 3.3 percent in 1987. As a result, unit labor costs have actually *declined*–by 0.4 percent in 1986 and 1.9 percent in 1987.

Unit Labor Costs in Manufacturing

(Index 1977=100)



The sharp drop in oil prices during 1986 was an important factor behind the deceleration in consumer price inflation during that year. Analysts point to the fact that steady oil prices during 1987 contributed to the 1987 rebound in inflation. Some analysts fear that renewed fighting in the Persian Gulf will result in higher oil prices. The opposite case, i.e., a lower oil price scenario, is just as likely, however. The fact of the oil situation is that OPEC has been unable to enforce production quotas for several years. Despite the fact that some non-OPEC producers have also shown an interest in curtailing production to support prices, the reality of the oil picture is one of plentiful supplies. Moreover, even in the face of an expanding world economy, consumption has not increased as rapidly as OPEC would like. In the meantime, many of the oil-producing countries have enormous debt burdens; they cannot afford to curtail production to prop up prices but must produce and sell to service their debts.

One of the most troubling prospects in the gloomy scenario on inflation is the lagged effect of the declining dollar. The fear is that sooner or later the dollar's decline, which began in early 1985, will be reflected in a major increase in domestic

inflation. So far, it appears that foreigners have sacrificed profit margins in order to maintain their U.S. market shares. That is, although the decline in the dollar's value has reduced their profits, they have generally refrained from raising the price of the products they sell in the United States. The assumption is that they may have exhausted their ability to continue to do this and will henceforth raise their prices. The fact that one of the major components of the March increase in inflation was apparel–a sector where imports play an important role–is offered as proof. But this reflects a relative price change, not an increase in overall inflation, as is explained below.

The evidence, therefore, seems to suggest that while we can expect further increases in inflation, it is unlikely that we are in for a replay of the 1970s experience. Indeed, few analysts expect inflation to rise faster than about 5 percent during the next two years. The consensus forecast calls for an increase of 3.9 percent in 1988 and 4.6 percent in 1989.

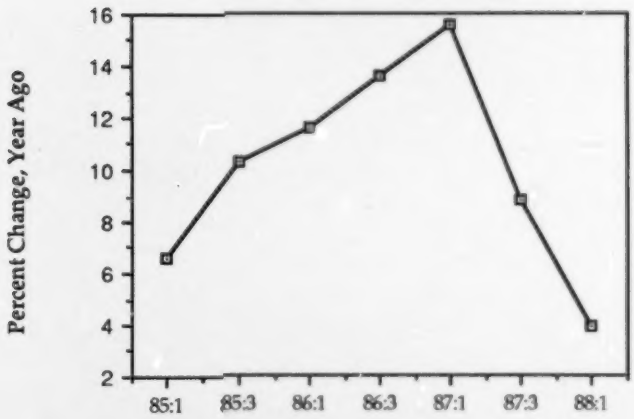
This analysis, however, is incomplete since it simply tells us that when prices increase we have inflation: a tautology. There are several points missing in this analysis. The first one is that economic growth *per se* is not inflationary. The supply and demand conditions just described presage moderate changes in *relative* prices; however, they are not necessarily an indication of future changes in the *overall* level of prices.

Inflation is a monetary phenomenon. At the micro level, a variety of factors affecting the cost and relative demand structures in individual markets can cause relative prices to change. For instance, a large increase in prices for imported goods, can cause large changes in the value of the consumer price index, as we saw in March. However, individual prices changing in relation to one another result, not in an increase in the overall price level, but in a reallocation of demand across markets. It is, therefore, incorrect to say that increases in the price of imports *cause* inflation.

The necessary condition in the inflation scenario is that there be no change in total spending or income beyond the capacity of the economy to produce. As long as changes in income remain within the productive capacity of the economy, the factors mentioned above cannot cause all prices to rise. It is the accommodating increases in the supply of money which, by raising the level of demand, removes the constraint on total spending and leads to a rise in the overall price level.

There is reason to be concerned about future inflation trends. It is the rapid increase in the money supply between the middle of 1985 and early 1987, which after a lag estimated at 12 to 24 months, will begin to have an impact on the rate of inflation. It is revealing to note that producer prices stopped declining in the second quarter of 1987, eight quarters (24 months) following a sharp and continued increase in the money supply. This accommodating increase in the money supply makes it possible for the emerging pressures on individual prices to be translated into increased inflation.

Increase in the Money Supply (M1)



Inflation watchers should be relieved to see the protracted tightening of money supply growth by the Federal Reserve. During the past three quarters, money supply growth has decelerated sharply. However, a moderate rate of money growth is a necessary but not a sufficient condition for a healthy economy: the money supply must also grow in a stable fashion. If this does not happen, we run the risk of being caught in a vicious circle where clamping down on the money supply reduces inflationary pressures and precipitates a downturn in economic activity. After a while, the lost jobs and production will increase the calls for an easing of monetary growth to allow for faster growth, completing the circle and increasing inflationary pressures again.

It is not slow economic growth that cures inflation, nor rapid growth that causes it. (Recall that the 1960s were characterized by rapid growth and low inflation while during the 1970s, we experienced slow growth and soaring inflation.) Rather, it is the rapid increase in the money supply that causes inflation to rise, and its volatility which thwarts growth.

In sum, it appears that the national economy has enough momentum to continue to grow with a declining rate of inflation. Whether or not the economy is able to maintain a path of stable growth depends upon the actions of the Federal Reserve. If the Fed overreacts to the monthly statistics, it can slow the economy significantly. As long as it continues to attempt to fine-tune the economy, the swings in the money supply are also likely to continue, as the Fed finds itself constantly reacting to the effects of its own past policies.

In the absence of clearly stated policy by the Fed, the financial markets pay undue attention to monthly inflation, employment and production data not in an attempt to discern trends in the economy, but in an attempt to discern what the Fed is likely to do next. The Fed would reduce financial market uncertainty if, immediately after each open market committee meeting, they announced their policy decisions and described how they intend to carry out the agreed upon policy.

A3840-11.16-F

U.S. Chamber of Commerce Economic Policy Division

Policy Working Papers

May 1988 *Number 16*

TREASURY REPORT VINDICATES 1981 TAX CUT

by Richard W. Rahn
Vice President and Chief Economist

The numbers are now in and they show that the Reagan administration's tax policies have produced a more progressive tax system. The fact is that the rich are now paying a much higher percentage of the overall tax burden than in 1980, according to a Treasury Department report on 1986 individual income tax data. And this was achieved in a manner that promoted, rather than retarded, economic growth, job creation and prosperity.

I still remember the hoots of derision when supporters of the Economic Recovery Tax Act of 1981 asserted that lowering the top income tax rate from 70 percent to 50 percent would increase both revenues and the share of the tax burden borne by upper-income taxpayers. Opponents vigorously disputed these claims.

Tax reformers then argued that tax rates were so high that they were actually costing the government revenue. By lowering the rates, workers would be provided with an incentive to earn more taxable income. This, in turn, would supply the government with increased revenues. Supporters gave four primary reasons for this:

- A lower tax rate would make ordinary taxable investment more attractive than tax shelters.
- By reducing the tax on employment income, lower tax rates would provide an incentive for taxpayers to do more productive work.
- The 1981 tax law would make investment more appealing by raising the after-tax return on investment.
- The 1981 reduction in the capital gains tax rate from 28 percent to 20 percent would reduce the tax cost of selling capital assets. Consequently, investors

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would be inclined to realize their capital gains more often and the government would benefit from the higher tax revenues.

The official Internal Revenue Service statistics reveal that the supporters of the 1981 tax cut were absolutely correct.

Between 1981 and 1986, the share of the total tax burden borne by the top one percent of American workers increased from 18.1 percent to 26.1 percent. And the portion carried by those earning more than $100,000 increased from 15.2 percent to 30.6 percent. In contrast, the bottom half of American taxpayers, the lowest 50 percent, paid only 6.4 percent of all taxes in 1986 compared to 7.5 percent in 1981. Those workers earning less than $50,000 paid 66.8 percent of all taxes in 1981 but only 45.7 percent in 1986.

Equally as impressive, the government collected almost three times more tax revenue from the affluent after their tax rates dropped. Taxes paid by those earning more than $100,000 increased from $43 billion to $115 billion during the 1981 to 1986 period.

The 1986 tax reform act continued the policy of reducing marginal tax rates. In spite of the act's many shortcomings, it reduced marginal tax rates on most income and cut the top tax rate to 33 percent beginning in January 1988.

These rate reductions will have a similar impact to those of 1981. Lower rates, combined with the tax shelter limitations in the 1986 act, will increase the actual taxes collected from upper income individuals dramatically. However, the increase in the capital gains tax rate from 20 percent to 33 percent beginning in 1988 may outweigh the benefit of lower tax rates on ordinary income.

Unfortunately, increasing the capital gains tax rate by 65 percent is bound to cost the government revenue and have a detrimental impact on venture capital formation and overall economic growth. Such increases in tax rates also tend to reduce the share of the tax burden borne by the affluent.

In both 1978 and 1981, the capital gains rate was reduced and capital gains realizations increased more than enough to compensate the government for the lower rate. In fact, research by the U.S. Treasury Department and by Professor Lawrence Lindsey of Harvard University indicates that the rate which maximizes tax revenues on capital gains transactions is between 15 percent and 20 percent. That is why the president's tax reform proposal originally contained a 17.5 percent capital gains tax rate.

Objective observers of the data will conclude that lower marginal tax rates are the

only reasonable policy. Only those who view economic success as something sordid, deserving punitive taxation, support high tax rates. Fortunately, most Americans do not want to punish economic success–particularly if it will cost the government revenue and slow the economy. In light of the evidence, lower taxes are the progressive policy option. And reducing the capital gains tax rates should be a priority for Congress.

Changes in the Distribution of Federal Individual Income Tax Payments 1981-1986

Shares of Tax Payments by Percentiles

Percentile	1981	1985	1986*	1981-85	Percentage Change in Shares 1981-86*
Lowest 50%	7.5%	7.2%	6.4%	-4%	-15%
51 - 95%	57.6	52.9	49.3	-8	-14
95 - 99%	16.8	18.0	18.2	+7	+8
Top 1%	18.1	21.9	26.1	+21	+44

Shares of Tax Payments by Income Category

Adjusted Gross Income	1981 Taxes Paid#	1981 Share	1985 Taxes Paid#	1985 Share	1986 Taxes Paid#	1986 Share
Under $50,000	$189.9	66.8%	$170.6	52.4%	$172.4	45.7%
$50,000 - $100,000	51.1	18.0	77.9	23.9	89.1	23.7
Over $100,000	43.2	15.2	77.3	23.7	115.4	30.6

Key: * Preliminary data
Dollar amounts in billions

Source: U.S. Department of the Treasury, Office of Tax Analysis
Internal Revenue Service, Statistics of Income Division

A3840 - 11.17 F

U.S. Chamber of Commerce Economic Policy Division 8/88

Policy Working Papers

June 1988 *Number 17*

FACTS AND FALLACIES ABOUT FOREIGN INVESTMENT

by
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Many stories are being written stating that the U.S. has become a second-rate country, moving from the world's largest creditor nation to the largest debtor in a short span of time. There are claims that foreigners are "buying up America" and gaining control of our political institutions by financing federal debt and altering state and local policies.

Other stories extoll the virtues of foreign investment in the U.S. According to these views, the U. S. is not a debtor in any meaningful sense—we do not owe more than we are worth nor even more than we produce—and foreign investment, rather than being a serious burden, has been, in fact, a boon to our economy.

This paper presents the ideas behind the scare claims, the types of congressional responses we've observed in recent months, the data on foreign investment, and analyzes the competing views.

The Case Against Foreign Investment in the United States

Critics of foreign investment present a broad attack in newspaper and magazine articles, congressional testimony, and books. There are eight major arguments they make to support their view. Each will be mentioned and then analyzed in turn.

1. *We have become a debtor nation. Repaying this debt will cripple our economy.* The critics of foreign investment use the supposed debtor status to label the U.S. a second-rate country.

2. *Foreigners are buying up America.* The arguments focus on reports of Japanese purchases of urban land and other real estate, especially in Hawaii and the western U.S.

3. *The growing dependence on foreign investors makes our future uncertain.* Like the familiar concerns over energy dependence, the notion presumes that the U.S. will suffer because of alleged dependence.

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4. *Foreign investment is a threat to our national security.* Critics argue that foreigners will buy companies dealing in defense and other sensitive areas to learn our secrets.

5. *Foreign companies and governments are gaining dangerous political influence over state, local, and national policymaking.* For example, city officials are criticized for competing for foreign investors by offering deals on taxes and other "giveaways."

6. *Foreign companies operating in the U.S. offer only menial jobs to U.S. workers.* Critics point to assemblage jobs as typical of the work in U.S. affiliates.

7. *There is not enough control or scrutiny of foreign investors.* In the 1988 trade bill debate, the so-called "Bryant Amendment" was aimed at greater scrutiny and control.

8. *Foreign investors produce here to avoid our tariffs and import quotas.* For example, Japanese automakers produce in the U.S. and their sales are not subtracted from import quotas.

Is the United States a Debtor Nation?

Near the middle of 1985, commentators began reporting that the U.S. had lost its status as the world's largest "creditor nation" and had become a "debtor nation." Utilizing historical data accumulated by the U.S. Department of Commerce, commentators asserted the U.S. became a debtor nation when the value of foreign held assets in the U.S. exceeded the value of U.S. assets held abroad.

Assertions of this sort, however, do not comport with accepted notions of what debtor status means. For example, a debtor can be construed as having negative net worth, owing more in liabilities than owning in assets. In the U.S., all assets—including corporate equity and bonds, government bonds, bills, and notes, real estate, wholly owned businesses, private wealth, bank assets, etc.—amount to about $30 trillion. U.S. net worth in 1987 exceeded $10 trillion. *And as of the end of 1987, total foreign holdings of U.S. assets amounted to approximately $1.5 trillion or about 5.6 percent of all U.S. assets.*

Another accepted way of looking at the burden of debt is to compare the amount of debt with a year's worth of income. U. S. GNP is approximately two and a half times the amount of foreign held assets in the U.S. That is, *U.S. income in one year is more than sufficient to completely buy out all foreign assets owners at once, a prospect no one seriously expects the nation to face.*

More realistically, only a small portion of U.S. GNP is required to satisfy foreign asset holders in the form of an annual rate of return. Whatever that amount must be, it will flow directly from private investments. All private investment in the U.S. is made on the basis of expected returns from that investment. Thus foreign asset holders are in the same position as U.S.. resident asset holders—their investments are the basis of future repayments.

In 1987, it was estimated that U.S. holders of foreign assets earned $6 billion more from these assets than did foreign holders of U.S. assets. *This suggests that the reported $1.1 trillion of foreign assets held by the U.S. were undervalued*—to be consistent with their higher income yield, foreign assets held by Americans should be valued above the $1.5 trillion held by foreigners.

There is reason to believe that this is the case. The reported book values represented historical costs. U.S. asset holdings were acquired earlier than foreign held assets in the U.S. This led one writer to conclude that the value of U.S. assets, when adjusted for changes in price levels, actually exceed the value of foreign held assets in the U.S. by $200 billion.

Consequently, the U.S. is in no meaningful sense in debtor status, with respect to its total assets and its ability to pay. Even by the questionable measure presented by the critics of foreign investment, the U.S. is not a "debtor nation" when the data are properly compiled.

It is also common sense that repaying foreign asset holders will not cripple the U.S. economy. The bulk of their assets in the U.S. generate their own return. These payments come from growth in the U.S. economy, growth that these foreign investments helped to generate.

Approximately $290 billion of the $1.5 trillion in U.S. assets held by foreigners is in the form of government securities. This represents 14.6 percent of total outstanding government debt, down from 1980 foreign holdings of 16.7 percent. This discredits the argument that foreigners are financing the U.S. government debt. If anything, foreigners have shifted from unproductive (for the U.S.) investment in bigger government into productive investment in the private sector. Repaying government debt, regardless of the holder of that debt, must come from general economic growth in the U.S.

What Motivates Foreign Investment?

Not only are the data poorly measured and their meaning misconstrued, but there is also fundamental ignorance of what motivates foreign investment. *Beginning in 1981, U.S. investment overseas dropped considerably, a drop that lasted until 1986. At the same time, total investment, including foreign investment, in the U.S. was increasing. It took off in 1985 with greatly increased purchases of U.S. corporate securities.*

The reason for the increase was the relative attractiveness of investment in the U.S. noticed first by U.S. investors who came "back to America" and later by foreign investors. The initial impetus in 1981 was a sharp rise in U.S. interest rates over those in other countries. Foreigners invested more heavily in debt instruments that payed dollars at a fixed rate because of a rising international value of the dollar, as well.

The second impetus was larger—the growth of the U.S. economy outstripped growth in the rest of the world since 1985. Accompanying this growth was a falling dollar which raised the attractiveness of equity investments to foreign investors.

It can hardly be said that the U.S. has become a second-rate nation similar to Brazil. The fundamental differences between the two countries are obvious. There is also a significant difference in the nature of each country's debt to foreigners. Brazil has borrowed from foreign banks to finance government programs aimed at development, and therefore, must repay its debt in other than its own currency. That is, to repay it's lenders, Brazil must earn dollars and other currencies through exporting.

The U.S., on the other hand, owes foreigners in its own currency, dollars. Dollars are earned from domestic economic activity as well as exports. Furthermore, *most of the U.S. repayment obligation is in the form of return on private investment. This "debt" to foreigners is no more "debt" than what American companies owe American investors.*

Neither U.S. taxpayers nor any other third parties "owe" foreigners for the risks of repayment they voluntarily accepted in purchasing private U.S. assets.

In summary, the U.S. is not a "debtor nation" by any commonly accepted standard. The measure that commentators use to make such charges are faulty and misleading. Repaying the bulk of foreign investment will be accomplished from our growth. And it is our growth which continues to spur increases in foreign investment in the U.S.

Are Foreigners Buying up America?

Recent reports of foreign investment in the U.S. tend to single out Japan as a big player in U.S. banking, hotels, urban real estate, and purchases of U.S. companies. However, Japan is a poor third to Great Britain and the Netherlands which are the largest investors in the U.S. Furthermore, as was mentioned above, *foreign investment of $1.5 trillion in the U.S. represents only 5.6 percent of total U.S. assets. Certainly foreigners as a whole, or any single country, including Japan, cannot be said to be buying up America to any significant degree.*

For the purposes of illustration, three major categories of assets can be analyzed—corporate equity, which includes direct foreign investment and holdings of corporate stock, private credit market debt, and U.S. government securities.

Foreign Holdings of Corporate Equity

As of the end of 1986, foreign direct investment in the U.S. totalled $209 billion. By definition, foreign direct investment represents foreign holdings of 10 percent or more in a U.S. company plus the total value of wholly owned foreign subsidiaries of foreign companies or, as they are called, U.S. affiliates. Of this total, Great Britain had $51.4 billion of direct investment, the Netherlands $42.9 billion, Japan $23.4 billion, Canada $18.3 billion, West Germany $17.4 billion, among the major foreign investors. Foreigners held an additional $310 billion in corporate stocks and bonds for a total investment in U.S. businesses of $519 billion. This represented only 4.1 percent of total U.S. private investment as of the end of 1986.

While the numbers are large (billions), the portion is small. The question is whether foreign purchases of U.S. assets are growing at an alarming rate. Between 1980 and 1986, foreign direct investment grew annually by an average of $21 billion. This translates into an annual compound rate of 10.3 percent for that period. Corporate stock purchases grew by an average of $17 billion per year, or an annual compound rate of 10.9 percent. However, in that same time span, 90 percent of the world's economic growth was concentrated in the U.S. Tax rates in the U. S. were reduced, making investment here more attractive relative to other countries. The value of corporate assets in the U.S. rose by over 12 percent per year.

Foreign investment in the U.S. has picked up since 1980, as well as U.S. investment in total. The percent of foreign holdings in U.S. businesses (4.1 percent) is almost the same as it was in 1980.

Foreign Holdings in U.S. Credit Markets

Looking at the private U.S. credit markets yields a similar story. Near the end of 1986, foreigners held $518 billion of private debt. This accounts for only 5.1 percent of total private credit, up about one percent from 3.9 percent in 1981. Again, this is a small portion of the total market and does not comport with a "buying up" of America scenario. Higher interest

rates in the U.S. have attracted foreign funds to U.S. credit markets and have kept U.S. savings at home.

Near the end of 1987, foreigners held approximately $290 billion of the then almost $2 trillion government debt. Their holdings, as reported above, represented 14.6 percent of all holdings, but this was down from 16.7 percent in 1981.

The recent emphasis on new foreign holdings appears to exaggerate the reality of the situation. In no meaningful sense are foreigners buying up America. *And the focus on Japan appears to be motivated by something other than the numbers. Overall holdings of U.S. assets by European countries stood at $745 billion at the end of 1987. Japan held only $187 billion, overtaking Canada's position in third place in 1986.*

Is America Dependent Upon Foreign Capital?

Among the catch words to raise alarm about foreign investment in the U.S. is the alleged "dependence" of the U.S. on foreign investors. Some commentators have remarked that the presence of foreign investors makes our future dependent upon their actions. And they seem to be saying our future is less certain because we can't trust foreigners.

These arguments make no sense when we analyze from whence these funds come to the U.S. The U.S. is currently running a trade deficit with most industrialized countries. This means that the value of our imports exceed the value of our exports. We are thus supplying the rest of the world with more dollars than they need to purchase our exported goods and services.

Foreigners who earn dollars can hold or trade them. Whoever ends up holding U.S. dollars can only spend them in the U.S. or in other countries, like Panama, who will accept U.S. dollars. If foreigners don't use dollars to buy goods and services, they can deposit them, loan dollars in return for securities payable in dollars, or buy U.S. assets. Ultimately, virtually all the dollars that left the U.S. come back as consumption, saving, or investment. Thus, the U.S. benefits from its imports—both merchandise and investments.

The size of the trade deficit means that the flow of dollars back to the U.S. will also be large. If it comes back as added consumption, this helps our export industries. If it comes back as savings, this keeps interest rates here down and helps satisfy U.S. investors who are seeking funds to borrow. If it comes back as investment, this adds to our growth and raises the value of our assets.

Concern over what foreigners might do represents more of a concern as to what form the dollars will be used. For example, suppose the Federal Reserve (Fed) stopped maintaining such high interest rates in the U.S. by supplying more credit itself and thereby discouraging savings in the U.S. by foreigners. Foreigners with dollars would then shift toward more consumption or investment. At first, however, those who held dollars might try to sell them on international currency markets leading to a depreciation in the value of the dollar. Such a depreciation would make our exports look more attractive as well as our assets because foreigners would have to spend less of their own currency to purchase our goods and assets.

The concern over what foreigners will do with their dollars is probably more of a political concern rather than a real worry about the U.S. economy. If the Fed and the U.S. Treasury want to stabilize foreign exchange rates, they must realize that foreign holders of dollars

(over whom they have little control) can thwart that policy. In fact, this is what we observe most of the time these days within policy circles. Maintaining the international value of the dollar requires more and more credit restrictions by the Fed when pressures for the dollar to depreciate become strong.

Thus to meet U.S. policy of stable exchange rates, we are in a sense dependent on the actions of foreign holders of dollars. But this is also true of any U.S. traders of foreign currencies whose activity in foreign exchange markets can affect the value of the dollar.

The problem may be with the adopted policy of attempting to engineer exchange rate stabilization, rather than letting the foreign exchange markets freely determine the value of the dollar. Maintaining the value of the dollar in the past year has placed, it is estimated, as much as 120 billion more dollars in the hands of foreign governments who have intervened to help support the dollar by purchasing them.

Instead of reducing the trade deficit by expanding exports and promoting growth in our economy which would, in turn, narrow the government budget deficit, foreign governments maintain the competitveness of their exports by buying dollars and using these dollars to purchase U.S. government securities. This has had the effect of thwarting improvements in our balance of trade. This is the prime reason for so much anguish about foreigners, including Japan, in the first place.

Discarding the policy of exchange rate stabilization would lessen the fear about the reactions of foreigners. It might also have a salutory effect on trade deficits and the government deficit as well.

Is Foreign Investment a Threat to our National Security?

Elliot Richardson considers the assertion that our national security is not safeguarded to be one of the key myths about foreign investment. In Senate testimony in March 1988, he points out that,

> like U. S. investors, foreigners must comply with all the laws on the books, the Securities and Exchange Commission reporting requirements, and antitrust laws. Then there are special restrictions for foreigners in certain key sectors such as radio and television, coastal and inland shipping, air transport and nuclear power. The Defense Department has a comprehensive set of regulations which limit or bar foreign ownership of companies that have government contracts involving classified information.

Thus, while foreign investors are treated like U.S. investors in general, they are proscribed from learning U.S. defense secrets. Operation control of the national security question is already in place involving several U.S. agencies who continually review applications of foreign investors. By using the national security scare [illegible]ment, critics of foreign investment are trying to lure sympathy from those [illegible]e a high priority on our security.

Do Foreign Companies and Governments Influence Domestic Policy?

Critics of foreign investment consider the competition between states and local areas to attract investors to be damaging to our political process. They assert that governments at these levels engage in giveaways to attract foreign investors. They point to "deals" on roads,

schooling, and taxes given to foreign investors as examples of how taxpayers subsidize foreign investment.

However, is this any different from treatment given to U.S. investors? Typically, local and state officials compete for investment with other states and localities. They offer incentives to invest in their area to spark economic growth and to increase their tax base. Comparable American investors receive the same treatment as the prospective foreign investor. By attracting sizeable investment, state and local officials expect to gain a larger tax base from the growth that springs from the investment.

At the national level, commentators have expressed concern over the large amount of dollars and U.S. government securities held by foreign governments. They claim that foreigners have a great deal of influence over monetary and fiscal policy since they may decide to sell those dollars and the securities they hold. This would cause a falling dollar and increases in U. S. interest rates.

Just the opposite impact on policy has occurred. *Foreign governments, at the behest of the U.S. government, have been acquiring dollars in the last year in large amounts to keep the value of the dollar up. Under agreements to stabilize the dollar, foreign governments have participated in promoting U.S. policy, not the contrary. They have used some of these dollars to buy U.S. securities also at the behest of our government thereby keeping interest rates down.*

Indeed, foreigners consider the dollar an international reserve currency. They have been concerned that U.S. fiscal policy has been over-stimulative and have lent their help in the only way they can to stabilize the dollar. Such reactions are hardly attempts to subvert U.S. economic policy objectives.

Do Foreign Companies Exploit U.S. Workers?

Commentators claim that U.S. affiliates offer assemblage jobs in the U.S. keeping the higher paying jobs at home. This represents an ironic reversal of the argument in the 1960s and 1970s, that U.S. investors were exploiting low wage foreign countries and exporting jobs from the U.S.

U.S. affiliates directly employ three million American workers and indirectly support millions more. They attract U.S. workers by offering work at the prevailing wages or better. Otherwise, they could not attract U.S. labor. While some of the jobs are assembly jobs, many are in the financial area and other service businesses. It is absurd to believe that U.S. workers are shortchanged or somehow exploited.

Is There Enough Scrutiny and Control of Foreign Investors?

Stricken from the omnibus 1988 trade bill was a provision, the so-called "Bryant Amendment", to require additional reporting and public disclosure by foreign investors. Critics of foreign investment supported this amendment to gain a purported improvement in knowledge about foreign investors. However, the requirements were onerous especially as ownership in a U.S. company increased to the point where disclosure would have shut off the flow of foreign investment to the U.S.

Furthermore, the U.S. Department of Commerce claimed that foreign investors were already carefully scrutinized and that public disclosure would greatly reduce the incentives to foreign investors to put their dollars back in the U.S.

One argument in support of the Bryant Amendment was since U.S. companies must reveal more detailed information in other countries that, in a retaliatory manner, we should require the same of foreign investors. Others, however, argued that critics of foreign investment are out to mimic the restrictions of other countries. To retaliate would be to do what they do, not what is right for America.

Does Foreign Investment Subvert our Tariffs and Import Quotas?

Critics of foreign investment claim that a major reason that foreigners produce here is to sell more products in America. U.S. affiliates can therefore avoid tariffs and import quotas on sales because their base of production is in the U.S. They argue that by selling more here, foreign investors thwart our policy of limiting their U.S. sales.

This argument is an extension of the protectionist sentiment that erected the import barriers in the first place. However, it loses some of its steam when applied to investment. One protectionist tenet is to protect American jobs. Yet foreign investment here adds American jobs.

Another aspect of this argument is that U.S. affiliates will tend to import more than do U.S. firms. This is indeed true. However, *U.S. affiliates account for more exports—roughly 26 percent of all U.S. exports. In the last six years, export growth of U.S. affiliates has far outstripped their import growth. Thus, trade by U.S. affiliates has on net reduced the U.S. trade deficit and added American jobs in direct accord with our stated policies.*

In Summary: The Case Against Foreign Investment

The arguments against foreign investment in the U.S. rely on misinformation, exaggeration and faulty analysis. What is left is traditional American fear of losing ground to outsiders, especially the Japanese.

Foreign investment in the U.S. is small compared to overall investment here. It does not subvert U.S. policy nor is there a threat to U.S. independence. The extent of investment in the U.S. is testimony to the strength of our economy and the stability of our business environment.

Protectionist sentiment appears to be a major motivating force behind the fears of foreign investment. Under this way of thinking, there must be something amiss, and they have searched for arguments to support their xenophobic suspicions. These arguments do not stand up under scrutiny. Protectionist ideas, in general, have never made any sense. But the suspicions don't seem to go away because of rational argument.

Foreign investment in the U.S. at least provides an opportunity to dispel some of the fears about foreigners by bringing them here to produce and to see first hand what foreign businesses can offer. It gives us a rare opportunity to bring to the U.S. new technology and management that may inspire future economic change for the better in this country.

The Benefits of Foreign Investment

Foreign claims on U.S. assets, including foreign direct investment, has resulted in more investment and savings in the U.S. Specifically, it has:

- Reduced interest rates in the U.S.
- Introduced new technology
- Expanded U.S. access to foreign markets through U.S. affiliates
- Added to our employment and growth

Conclusion

Capital flows into the U.S. are stimulated by prospects for high return here. U.S. dollars earned through our imports are a highly valued commodity internationally because they can be used to purchase U.S. products and buy U.S. assets. Restrictions on foreign investment would lower the value of the dollar internationally and the value of U.S. assets.

U.S. affiliates of foreign companies add to our trade balances by exporting more than they import. During the early 1980s when the dollar was valued much higher and interest rates made saving in the U.S. attractive, dollars flowed into bank accounts and credit markets. As the dollar fell, foreign investors shifted to real and corporate assets to attempt to capture the gain from U.S. growth. Thus, foreign investors have acted in concert with U.S. investors in the 1980s.

The largest foreign investors are important allies of the U.S. Restrictions on foreign investment would tend to threaten these strong relationships and heighten our concern over national security. The U.S. is still the world's largest investor in other countries despite obstacles to investment in other countries. This is because we, like foreign investors, desire to be closer to markets in order to serve those markets better.